



Early Journal Content on JSTOR, Free to Anyone in the World

This article is one of nearly 500,000 scholarly works digitized and made freely available to everyone in the world by JSTOR.

Known as the Early Journal Content, this set of works include research articles, news, letters, and other writings published in more than 200 of the oldest leading academic journals. The works date from the mid-seventeenth to the early twentieth centuries.

We encourage people to read and share the Early Journal Content openly and to tell others that this resource exists. People may post this content online or redistribute in any way for non-commercial purposes.

Read more about Early Journal Content at <http://about.jstor.org/participate-jstor/individuals/early-journal-content>.

JSTOR is a digital library of academic journals, books, and primary source objects. JSTOR helps people discover, use, and build upon a wide range of content through a powerful research and teaching platform, and preserves this content for future generations. JSTOR is part of ITHAKA, a not-for-profit organization that also includes Ithaka S+R and Portico. For more information about JSTOR, please contact support@jstor.org.

Real Estate Bonds as an Investment Security

By GEORGE A. HURD

President, The Mortgage-Bond Company of New York

REAL ESTATE BONDS

REAL estate bonds are obligations secured by mortgages or trust conveyances of real estate. While any mortgage may secure a series of bonds instead of a single bond or note, which might thus be called real estate bonds, they would not differ in any way, except that of convenience, from the ordinary mortgage transaction. What is meant by "real estate bonds" or mortgage bonds in the investment sense is a series of bonds in convenient denominations secured by real estate mortgages, the bonds being issued by a financial company formed for that purpose and itself obligated on them. Such mortgage companies have been developed so long in Europe that any study of the system must include an examination of the history of the development of the mortgage business in Europe, and other parts of the world subject to European influences, as a prerequisite to the understanding of real estate bonds as an investment security in this country.

In considering such bonds, it is essential to examine them from the standpoint of the fundamental requisites of all good investments, namely, safety, interest return and convertibility. Of these requisites, that of the safety of the principal under all conditions which may arise is by far the most important and the one to which most consideration will be given.

WHEREIN RESTS THE SECURITY OF REAL ESTATE BONDS

Stability of Productive Power of Land.

—It may be said at the outset that the principal advantage which real estate has over other forms of security rests in the certainty or stability of its productive power. All value in real estate is the result of income capitalized. In the case of city real estate, the natural causes which lead to the growth of cities in certain locations create a permanent demand in those locations for areas on which to live or transact business. Such advantages in location are paid for in the form of rent, and as long as a community exists there will be income from the use of locations within it, and real estate values founded upon this income. In regard to farm lands, the productivity of the soil creates an annual income, a part of which, as rent, may be capitalized into value. As long as the soil is productive, income, and therefore real estate values, will exist.

Convertibility of Capital.—So large a part of the world's wealth consists of real estate, that the use of it as security for debt has been a matter of the most vital importance in the commercial progress of the race, since it gave to land a partial convertibility and prevented the capital invested in real estate from being wholly fixed. Down to the beginning of the last century, however, mortgages were restricted to

transactions between individuals who had personal knowledge of the particular property offered as security. This necessarily confined possible mortgage lenders to those residing near the property on which a mortgage was desired, and, as capital could not move freely to the places where it was most needed, great differences in interest rates existed between different localities.

FACTORS ENCOURAGING MORTGAGE ASSOCIATIONS

Among other disadvantages attending this condition of things was the fact that the effort to find individual lenders, having the exact amount needed, made it unduly expensive to obtain loans and resulted in economic waste through unnecessarily high commissions. Individuals were also unwilling to make long-time mortgage loans which were nearly or quite inconvertible in their hands, and this resulted in forcing borrowers to pay commissions for obtaining new loans at comparatively frequent intervals, and in exposing them to the risk, at each maturity, of being unable to replace the loan. Individuals, also, did not ordinarily wish to have their capital returned to them a little at a time, but wanted the full sum at the termination of the loan. This prevented the use of amortization loans, or loans that are paid off by degrees throughout the life of the loan. This type of loan, which is almost universal on the continent of Europe and which is coming into more frequent use in this country, so greatly increases the safety of mortgage investments that the resulting reduction in interest rates may be sufficient to enable a borrower to pay off a loan in forty or fifty

years, by an annual payment for principal and interest no greater than the payment for interest alone would be, were the loan without the amortization feature. It may be added that loans for fifty or seventy-five years would be for too long a period to be safe, unless for a constantly decreasing amount.

Perhaps the greatest single objection, however, to the old system of conducting the mortgage business arose from the fact that most individual investors could not be mortgage experts, and as a result frequent and serious losses were made, which tended to increase the whole level of interest rates.

So serious were these objections that in 1770 the first association for conducting the mortgage business was formed with government assistance. Before describing such an association it may be well to say that there exist side by side in Europe these mutual associations which deal largely, if not exclusively, in farm loans, and mortgage-banks, or stock companies, for dealing both in city and farm loans, the latter having appeared almost simultaneously in various countries of Europe about 1835. These two forms of conducting the business operate through the same method, which is to make mortgage loans and then issue their own bonds secured by an equal amount of mortgages.

MUTUAL MORTGAGE ASSOCIATIONS

General Characteristics.—While there are, of course, differences between the laws governing mutual mortgage associations at different times and in different countries, the great majority have certain principles in common. They are formed with their borrow-

ers as members, and each member is responsible for any loss of the association through bad loans; a condition which acts as a check on the committee of members which approves applications for loans. They began, generally, by making loans, not in money, but in bonds of the association, which the borrower then had to sell for the best price he could; though, as a surplus was accumulated, this feature was given up and the loans made in cash, the bonds being sold by the association. Their loans are long-time loans, generally from fifty to seventy-five years, with an annual payment sufficient to retire the principal of the loan, and with privileges of anticipation. The associations are also restricted by law as to the locality in which they may make loans, the character of the property they may loan on and the margin of security they must have.

Central Associations of Northern Europe.—A later development in some of the countries of Northern Europe has been a central association, which makes no loans itself but issues bonds secured by the less well-known bonds of local associations, thus obtaining a lower rate of interest through having better credit. The mortgage companies proper are stock companies, which are conducted along lines similar to the associations and are subject to similar legal restrictions. There is, of course, no individual responsibility to make good the losses resulting from bad loans, the place of this being taken by the capital and surplus of the company, and by the limitation by law of issues of bonds to a certain number of times the capital.

The Credit Foncier of France

The Credit Foncier of France, founded in 1852, is the largest and most widely known of all mortgage companies, and the magnitude of its operations may be judged by the fact that for many years past its outstanding bonds have amounted to between 3,000,000,000 and 4,000,000,000 francs, while its credit is so good that the rate of interest on its bonds had dropped some years ago to 2.60 per cent, though more recent issues, even before the war, were at higher rates. There are in France in addition to the Credit Foncier, which enjoys special privileges from the government, and, consequently, has no rivals, only small local mutual associations for making farm loans in restricted districts. More than two-thirds of the mortgage loans of the Credit Foncier are on city property, and the remaining one-third on farms. Although in the early years of the company's history a great majority of the city loans, in amount, were on property in Paris, the loans in other French cities have for some years past exceeded those in Paris, the company thus showing a growing tendency to distribute its loans more widely.

Mortgage Companies in Italy, Spain and Portugal

In Italy, Spain and Portugal the example of France has been followed, and one large company is authorized to conduct the business of issuing mortgage bonds and is given valuable special privileges. Throughout the rest of Continental Europe the

mortgage business has been developed through the dual system of mutual associations and stock companies. British, French and Dutch companies also exist for loaning in North and South America, Africa and other parts of the world.

Mortgage Business in England

An exception to the general prevalence of this system is England, whose example has largely influenced the United States, though it is doubtful if the causes which led to a different development of the mortgage business there are applicable here. England has no mortgage company loaning on English property and organized on lines similar to those on the continent, though English and Scotch companies operating in the United States, Canada, Australia, Cape Colony, Natal, Mauritius, Argentina and Peru, issue bonds in the same manner as the European companies. One of the principal reasons is, no doubt, the prevalence in England of long-time ground leases which do away with much of the necessity for mortgages, since instead of owning the fee with his own capital and borrowing on mortgage for improvements, the tenant under a long lease puts his own capital into the improvements and pays an annual ground rent in place of interest on a mortgage. Then, too, legal restrictions, such as the life-estates and entails commonly met with in England, are great obstacles to the mortgaging of property. And it must be remembered, also, that since the security in England depended to an unusual degree on questions affecting legal titles, the mortgage business naturally fell largely into the hands of

lawyers, who still control a great part of English mortgage investments.

REASONS FOR STABILITY OF MORTGAGE ASSOCIATIONS IN EUROPE

It is too early yet to measure the effect of the war upon the mortgage companies of Europe, but it is a striking fact that up to the time of the war there had never been a failure of a European mortgage company or association, with insignificant exceptions due to dishonest management. Such long-continued safety and success make it interesting to examine the safeguards established by law with a view to preventing losses on bad loans. The principal of these are four in number, and have to do with the class of real estate accepted, the percentage of value to be loaned, the limitation of the volume of bond issues in proportion to capital, and the requirement of annual payments in reduction of the principal of loans. While some variations are naturally found in different countries, the underlying basis is found on examination to be surprisingly uniform.

Class of Real Estate Accepted

Taking up first the class of real estate accepted, we find that no company is allowed to loan on vacant land or unproductive property. The restriction is sometimes expressed in this way: "The company shall make loans only on property yielding a permanent and sure income." Hence, no loans are permitted on mines and quarries. To these prohibitions the Credit Foncier adds theatres, mills and factories, except where valued at what they would bring if sold for a different purpose.

Many other companies prohibit

loans on factories, and, in addition, loans on "uninsured buildings or country houses without land." The same principle prohibits loans "on country castles or on buildings which cannot be rented separately from the estates to which they belong," while in some instances a company is only permitted to loan "on buildings that have been in use for three years." Undivided interests in property are universally excluded as security.

Limitation of Percentage of Value to be Loaned.

The second safeguard is the limitation of the percentage of value to be loaned. With very few exceptions, no companies or associations are ever allowed to loan more than $66\frac{2}{3}$ per cent of the value of the property, the limitation being sometimes $66\frac{2}{3}$ per cent of the value of land and 50 per cent of the value of buildings. Many companies of Central Europe are limited to 60 per cent of the value, and some to 50 per cent, while loans on vineyards and forests cannot be made for more than $33\frac{1}{3}$ per cent.

Turning to other countries, we find that the Credit Foncier of France is limited to 50 per cent, except on forests and vineyards, where the limit is $33\frac{1}{3}$ per cent. In Italy the limit for mortgage companies, originally placed at 50 per cent, was raised in 1881 to $66\frac{2}{3}$ per cent. In Belgium the associations are limited to 50 per cent, though the mortgage companies loan up to $66\frac{2}{3}$ per cent. In Denmark the companies are limited to 60 per cent on land and 50 per cent on buildings, while the associations are limited to 50 per cent on land and 40 per cent on buildings. In Norway the limit is 60 per cent on all

farm loans and loans in Christiania and Bergen, while it is 40 per cent to 50 per cent in other towns. In Sweden the limit is generally 50 per cent, though the one mortgage company there has been raised to 60 per cent. In Argentina and Mexico the limit is also 50 per cent.

These limitations may be compared with the limitations imposed by law in this country for the mortgage investments of trustees and savings banks, and those generally adopted by custom. In New York State the limit for trustees is $66\frac{2}{3}$ per cent and for savings banks 60 per cent, while, except in a few other large cities, 50 per cent is a maximum, and in smaller cities and newly developed agricultural districts loans are not often made for more than 40 per cent of the value. It should be stated, however, that the delays incident to foreclosure are much greater here than in Europe, with correspondingly greater accumulations of delinquent interest, taxes and costs, so that our loans are, in fact, for larger percentages than they appear to be. In some cases European companies have the right to take immediate possession after default, the Credit Foncier having to wait but eight days, and the Banco Hipotecario of Spain only two days.

Amount of Bonds that May Be Issued

The third limitation established has to do with the amount of bonds which may be issued with a given amount of capital. The surplus is in all cases treated as a separate and special fund, and the usual legal requirements are that a percentage of the earnings amounting to 10 per cent or 20 per cent be set aside annually until the surplus

equals 20 per cent or 25 per cent of the capital of the company. The Credit Foncier of France is limited in its issues to twenty times its capital stock. This was, until about twenty years ago, the generally recognized limit in Central Europe also, but since then the limit has been placed at fifteen times the capital. Among companies restricted to ten times their capital stock are the Italian companies under the law of 1884, the Swedish Company, the Banco Hipotecario of Mexico, and the greater number of Dutch mortgage companies, though the latter are restricted to ten times the *subscribed* capital, only a fraction of which is paid in. Norway limits the issues of its mortgage company to eight times, and Denmark its companies to six times their capital. The English and Scotch companies, which loan only outside of Great Britain, follow a different plan and usually limit their bond issues to an amount equal to their subscribed capital, or even to the unpaid portion of it. At first thought this would appear to be more conservative than the continental method of allowing issues up to fifteen or twenty times the capital, but it may well be doubted whether the continental method is not, in fact, the safer, since with a large volume of business, profits are satisfactory from a small difference in interest rates between the bonds and the mortgages securing them, and the temptation is removed of taking risky loans at higher rates of interest in the attempt to earn greater profits through a wider margin of difference in rates, where the volume of business is small. Incidentally, it may be mentioned that the Credit Foncier, and the Credit Foncier Canadian, are limited by law

to a difference in interest rates on their loans and their bonds of $\frac{6}{10}$ of 1 per cent, the Italian companies, and more recently the Italian National Bank, to $\frac{45}{100}$, and some other European companies to 1 per cent, thus recognizing the danger of attempting to make large profits out of loans at high rates of interest.

Other Safeguards to Securities

The limitation of the territory in which loans may be made, and the general requirement of annual payments in reduction of the principal of loans, together with a rigid government inspection, furnish additional safeguards, as does also the further requirement that any property taken under foreclosure must be promptly sold, thus preventing a company from speculating for a future possible rise in the value of its foreclosed real estate, and concealing its losses by carrying such foreclosed real estate as an asset at cost, regardless of its real depreciation.

ELEMENTS OF RISK TO BE COVERED IN MORTGAGE LOANS

As has been shown, the companies engaged in issuing real estate mortgage securities in Europe are now safeguarded by a body of laws which have gradually grown up on this subject, and by which they are governed in accordance with past experience. In order to insure complete safety to investors, the business of making mortgages and issuing securities against them is one which should everywhere be closely controlled by law, as may be realized from a consideration of the varied elements of risk to be guarded against. While many of these elements, against which the margins on mortgage-loans

are to guard, are the same in farm loans as in city loans, the problems in farm loans are on the whole much simpler, the quality of the soil, the annual rainfall and transportation facilities being the essential elements to be considered.

In the case of mortgage loans on city property, however, the margin to insure safety must be sufficient to cover the following elements of risk:

- (1) Errors of judgment in valuing property.
- (2) The lowering of real estate values by general commercial and financial depressions.
- (3) Loss of value by changes in the internal structure of cities.
- (4) Depreciation of buildings.
- (5) Accumulations of delinquent interests, taxes and costs during foreclosure.
- (6) Loss of value through disposing of property at forced sale.

Errors of Judgment in Valuing Property

We shall consider each of these factors in order.

Since each piece of real estate stands by itself, there can never be a "market value" for it in the sense that there is for bonds or shares of stock, where each sale is representative of the entire issue. The valuation of real estate must rest on opinion only, and while it may be comparatively easy for an expert with full information to value real estate correctly in an active market, in a market where transactions are few the difficulty is very great. In order to have appraisals of any value, a real estate expert must have at his command a large fund of information in regard to sales of property, rentals of property, and the cost of construction

of buildings, since these are indispensable to a proper valuation of the real estate. It is not always easy to obtain information in regard to the consideration for sales, especially in New York City, where the practice is growing of setting out a nominal consideration of one dollar in deeds conveying property. The insertion in deeds of fictitious considerations must also be guarded against, such considerations being sometimes placed at a figure above the selling price, in the hope of giving the property a fictitiously high value, and less frequently at a figure below the actual selling price, in the hope of obtaining a lower assessment for purposes of taxation.

The selling price of property is ordinarily based on the rental of the property, which is the source of its value, but this is modified by the prospect of the future rental of the property. The ordinary method of appraisal of improved property is to add to the estimated land value the present cost of the buildings, with an allowance for age and depreciation. The aggregate of these values should always be checked wherever possible by capitalizing the net rentals of the property, after deducting expenses of all kinds, to find if the building's commercial value is equal to its structural value. Wherever a building is misplaced or badly designed, loss of income over a period of years is a sure result; and examples could be given of many expensive buildings, the cost of which has been entirely thrown away, as is shown by the fact that the net rentals produced by them have been less than those produced by adjacent properties improved with buildings of trifling cost. The structural value of the im-

provements, considered by itself, is therefore an entirely unsafe guide in such cases.

On the other hand, to rely on the amount of the net rentals without considering the proper rate of capitalization would be unsafe, since different classes of property are capitalized on a different interest basis. For example, a retail store property rented on a long lease to an entirely responsible tenant might be capitalized on a basis of 5 per cent net return, while a tenement house with a large number of tenants and corresponding vacancies and difficulties of collection would be capitalized at a considerably higher rate.

Effect of Commercial and Financial Depressions on Real Estate Values

Mortgage loans ordinarily cover so long a term of years that general financial and commercial depressions during the life of the loans cannot be foreseen, and loans should have margin enough to cover shrinkage of value due to this cause. A period of general industrial depression has a powerfully depressing effect on real estate, but this effect varies greatly on different classes of property. When a mortgage loan is made for a term of years, if the borrower pays his interest and complies with the covenants of the mortgage in regard to taxes, insurance, etc., the principal of the loan cannot be called, nor can additional security be called for, no matter what the decline in the value of the property mortgaged may be. A great distinction is thus apparent between mortgage loans and ordinary bank loans; and when a loan is made for the usual term of five years, it should be borne in mind that the property, to furnish adequate security,

should at all times during the five-year period show a comfortable margin above the amount of the loan. We are familiar with the recurrence of panics every twenty years with intermediate depressions of less violence at ten-year periods.

The effect on real estate of these greater and lesser panics is, however, not directly commensurate with the financial and commercial disturbance which they cause. A reason for this is probably to be found in the fact that the growth of population in American cities has been, ever since the foundation of our government, conspicuously greater in the alternate decades coinciding with the lesser or intermediate panics. The effect of this has been to offset the effect of intermediate depressions, as far as city real estate is concerned, because the abnormal growth of city population has coincided with that general period, while the relatively slow growth of cities during the decades coincident with the greater panics aggravates the depression of real estate following these panics.

During the period of depression following a great panic, individuals of every community are forced to restrict their expenditures to the most necessary objects, and the result of this is that the classes of property within a city which maintain their value best are the two indispensable classes of ordinary business and ordinary residence. All properties devoted to special uses, such as theatres, clubs, hotels, churches, etc., as well as factories and warehouses especially suitable to a single line of business, suffer severely. During such a period, also, all properties which, on account of the growth or movement of a city,

have a value based on expectations of higher rentals in the future are greatly depreciated, since the element of value based on future expectations is largely eliminated. This depreciation applies especially to suburban land, or that at the circumference of a city which is just coming into use, and is aggravated if the growth of a section has been artificially stimulated by capitalistic influences. The difficulty of valuing property during a period of depression is greatly increased just at the time when, through falling rentals and values, it is most necessary to be careful in making mortgage loans. This arises partly because the number of real estate transactions is greatly reduced and information from this source is thus largely cut off, since no property owner will sell under such conditions except through necessity; and also because of the difficulty of forecasting future rentals where vacancies exist, it being a hard matter to judge whether these are to be temporary or long-continued. To avoid the difficulty which arises from a lack of information about sales, the most feasible method is to prepare a scale of relative values for a city, so that a few real estate transactions in different localities will tend to show a drift of values, just as an inspection of the daily fluctuations of a half dozen prominent stocks tends to show the drift of fluctuations for the whole list of securities.

A further effect of a depression of values on different kinds of property, not usually given sufficient consideration, is the great difference which a reduction in the gross rentals of property makes in the net rentals, where the expenses of the property are heavy, as contrasted with the slight effect which

such a drop in gross rentals has where the expenses of a property are light. This is readily shown by contrasting a modern office building, which normally has expenses amounting to about 50 per cent of its gross rentals, these expenses including not only taxes and insurance but heat, light, elevator service, janitor service, etc., with a store building of moderate height where the expenses do not amount to over 15 per cent of the gross rentals, the owner having no expenses except taxes and insurance. If we assume a drop in gross rentals amounting to 30 per cent, the drop in net rentals of the office building will be 60 per cent, while the drop in net rentals of the store building amounts to only about 35 per cent. Since values follow rentals, the stability of value of a property that is less expensive to operate tends always to be greater than that of a property which is more expensive to operate. Careful lenders are, therefore, disposed to exercise the utmost caution in loaning on large buildings, such as office buildings, hotels and apartments, the expenses of which are heavy.

Loss of Value through Changes in the Internal Structure of a City

There is always going on in a city a movement of the retail stores in the direction of the best residence district, this being an effort on the part of the storekeepers to approach as closely as possible to their customers. As this district moves forward it leaves a vacuum behind it, which is filled later by wholesale dealers or is used for other purposes which are inferior from a rental standpoint. Unless the growth of a city is so rapid as to make its wholesale property worth as much as retail

property was a few years before, there will be an actual drop in the value of the property so replaced by wholesale. Where there has been a change of axis of the main retail business streets of a city, there has always occurred a shrinkage of the values created by an anticipated growth of the business district in the line of its original direction. Many examples are to be found in American cities of the best retail business streets being parallel to a lake or river front during the growth of a city up to a population of perhaps 50,000, while, after that point in population has been passed, the concentration of the best residence district at a distance from the water front has drawn business out towards this residence district, on lines at right angles to the water front and to the original business streets.

As regards wholesale and warehouse property, the chief danger to be guarded against arises through changes in the location of transportation terminals. The natural tendency of wholesale property is to place itself between its transportation facilities and the best retail business district, so that it may at the same time be able to handle its goods cheaply and yet be in a location convenient for its customers. Where the wholesale business of a city grew up through river transportation, it is noticeable that of late years the predominance of railroads has been so great as to withdraw wholesale business very largely from locations occupied by it for half a century, with an increase of value near the railroad terminals and a corresponding decrease of value near the wharves.

In the case of residence property, purely social reasons are the predomi-

nant ones in establishing high values, and property of this character is for this reason liable to depreciation through changes of fashion. Changes of transportation are also of great importance in determining residence values, improvements in street-car facilities and the general use of automobiles enabling people of a good social class to live at greater distances from the business center of a city and among pleasant surroundings. The effect of this has been to equalize the value of residence property which is close to business property, while rapidly enhancing the value of well-located property further out. Well-developed residence districts at a distance from the business center of a city have an element of stability in the fact that they are less likely than those closer to the business center to be injured by the encroachment of nuisances. In the term "nuisances" may be included buildings for every kind of utility except residence, since homogeneity is necessary to the maintenance of value in a residence district.

Depreciation of Buildings

Mortgage loans are usually made for a long enough term to have the improvements lose appreciably in value from age and usage during the life of a loan, except in cases of the most expensive construction. The loss through depreciation where a building is kept in good repair is estimated at $\frac{1}{2}$ per cent a year for the highest type of fire-proof construction, and increases for different classes of buildings to a maximum of 5 per cent a year for cheaply constructed workingmen's cottages. If improvements are not kept in good repair—and it is practically impossible

for the mortgagee to compel repairs to be made—the further depreciation from this cause must be added.

In addition to the depreciation of buildings through age and usage there frequently occurs a further and more serious depreciation due to changes in style or new methods of construction, or to a change of utility in the location. An example of such a change in style in detached residences has been the abandonment of the mansard roof, once popular throughout the United States, with the result that residences built in this style of architecture depreciated heavily in value, regardless of the soundness of their structural condition. Other changes in fashion affecting residence values are the abandonment of narrow hallways and of stained glass and other exterior ornamentation, together with the addition of newer and better methods of heating and lighting houses.

As regards business property, the erection of modern fireproof buildings frequently takes away a large part of the value of the older buildings with which they compete; and the failure of architects formerly to plan their store buildings with the ground floor frontage all open for the display of goods, has greatly depreciated the value of older buildings, or has led to their reconstruction along modern lines at great expense.

A further element of depreciation comes when there is a change of utility in the location. If a residence property has become suitable only for business, the value of the improvements disappears entirely, and the same is true of any such change of utility, subject of course to the possibility of saving a portion of the value of existing im-

provements through their reconstruction for a new purpose.

Accumulations Pending and During Foreclosure

The amount loaned on property, practically speaking, is not the face of the loan, but the amount of the debt with all its accumulations at the time of realizing on the property which has secured the debt. These accumulations are usually made up of delinquent interest, delinquent taxes (with penalties and a high rate of interest), delinquent street improvement taxes (with penalties), court costs, attorneys' fees, repairs after obtaining the property, and a real estate commission for selling, which varies from a little over 1 per cent in New York up to 5 per cent in smaller communities. In addition to these, there is a total or partial loss of interest from the time of commencing suit until the property is finally sold. In the aggregate these accumulations vary from 10 per cent of the face of a loan to a maximum of 40 per cent in cases of small loans where the laws are unfavorable to lenders.

These variations in the amount of the accumulations attract attention to a comparison of the laws of the various states in regard to mortgage loans. One of the commonest provisions in Western states, and one which adds largely to the accumulation, is the provision of law granting to the mortgagor a period after judgment of foreclosure within which he may redeem the property by paying to the judgment creditor the amount of the judgment with interest. This provision seems to have come into existence in states where mortgage loans on agricultural property predominated, with a

view to avoiding the serious effect on farmers of a single crop failure; and since such laws must be uniform in their operation they apply to loans on city property as well. This period of redemption varies from nine months in Nebraska, and a year in most of the Rocky Mountain and Pacific Coast States, to eighteen months in Kansas and two years in Alabama. The effect of this law is to prevent outside investors from buying at foreclosure sales, since they cannot be sure that the property will not be redeemed by the mortgagor by payment of the judgment and interest; and it also prevents a mortgagee, during the period of redemption, from improving property and obtaining larger rentals, for the same reason. Where, as in a few of the Middle Western States, the mortgagor remains in possession during the period of redemption, the accumulation is much greater, since during this period the mortgagee is entitled to no rental return at all, and a further action at law may become necessary to obtain possession. Other legal features which affect the amount of the accumulations are those which permit interest to be compounded, which permit penalty rates of interest, both on delinquent principal and interest, and large contractual attorneys' fees. Obviously the element of time is the principal one, and, where a mortgage may be foreclosed and the property obtained in a short time, the accumulations will be small. In this respect the laws prevailing in the Southern States appear to be more favorable to lenders than those in any other part of the United States.

Loss of Value through Forced Sale

Though properties seldom have to be bought by the mortgagee at foreclosure

sales in Europe, it is still the common rule in the United States, largely owing to defects in our mortgage laws. As has been pointed out, the time necessary to obtain title or sell the property at foreclosure sale in Europe is, generally, very much less than it is anywhere in the United States, and is generally less in the Eastern and Southern States than in the Western. Is it usually in the largest cities only, however, that there is any speculative market furnishing a demand for properties of all kinds, at all times, at a reduction in price from the normal value. Outside of New York City there is practically no auction market for real estate, and in most, though not all, of the smaller cities, properties are sold generally to those who intend to use them personally. Where, therefore, a quick sale is desired, a surprising difference will be found in different communities and on various classes of property; some cities having an active market which will absorb any good property offered at a price within perhaps 5 per cent to 10 per cent of its full value, while in other cities it is difficult to obtain within 25 per cent of the full value obtainable under favorable circumstances.

SECURITY OF REAL ESTATE MORTGAGE BONDS IN THE UNITED STATES

These varied elements against which the margins on real estate are to guard, and with respect to which the European laws compel certain safeguards, can be equally guarded against by the mortgage bond companies in the United States, by the incorporation, in the trust agreement between the issuing company and the trustee for the bondholders, of covenants respecting the character of the mortgages to be deposited, the specific performance of

which may be compelled by a suit in equity, in addition to rendering the company liable at law for any breach. This feature of the security for real estate mortgage bonds is so vital that it may be well to quote in full from the trust agreement of an American mortgage bond company the article bearing on the mortgages which may be deposited:

1. That each and every mortgage, which it shall at any time assign to and deposit with the trustee under this agreement, shall be a first lien upon improved real estate in a city situated in the United States of America, having a population of not less than 40,000, for an amount not exceeding one half of the value of the mortgaged property as appraised for the company, except that in cities having a population of not less than 300,000 such mortgage may be for an amount not exceeding three-fifths of the value of the mortgaged property as appraised for the company, and that within the political boundaries of New York City such mortgage may be for an amount not exceeding two-thirds of the value of the mortgaged property as appraised for the company. The term "city" is used throughout this instrument in the economic sense, to designate an urban community, and without reference to its political boundaries.

2. That it will not assign to and deposit with the trustee under this agreement any mortgage on a single building which shall exceed an amount equal to \$2 for each inhabitant of the city in which the property is located.

3. That the aggregate unpaid principal amount of all mortgages forming portion of the trust fund upon property in any one city will not exceed in amount \$2 for each inhabitant of such city per \$1,000,000 of the company's bonds issued and outstanding and secured by this agreement.

4. That the aggregate unpaid principal amount of all mortgages forming portion of the trust fund upon property in any one city shall not exceed in amount 20 per cent of the total amount of the company's bonds issued and outstanding, unless such mortgages are upon property situated within the political boundaries of New York City.

5. That the aggregate unpaid principal of all mortgages forming portion of the trust fund

upon property in any city of from 40,000 to 70,000 inhabitants shall not exceed a total of \$40 per inhabitant, and in cities of from 70,000 to 100,000 inhabitants shall not exceed a total of \$50 per inhabitant.

6. That no single bond or mortgage shall be assigned to and deposited with the trustee under this agreement which shall exceed in principal amount 10 per cent of the capital and surplus of the company then outstanding.

7. That the appraised value taken as a basis for the mortgage loans is not to exceed the selling value determined by the company by careful investigation. In arriving at this value only the established utility of the property and the earning power under systematic management will be considered.

8. That such appraised value of properties, securing bonds and mortgages assigned to and deposited with the trustee under this agreement, shall be in all cases based on two appraisals, one of which shall be made by the company's appraiser in the city where the property is located, and the other shall be made by a representative of the company in the home office, who shall have personal knowledge of values in all the cities in which he makes appraisals. From time to time the board of directors shall issue instructions to the appraisers touching the methods to be employed in fixing the value of properties on which loans are to be made. No mortgage shall be assigned to and deposited with the trustee unless it has been approved by the executive committee of the company. In case any mortgage amounts to \$100,000 or over, a third appraisal shall be obtained, made by an additional appraiser selected by the company.

9. That the bonds and mortgages which it shall assign to and deposit with the trustee under this agreement shall in no case be secured by farm property, unimproved property, undivided interests in property representing less than the entire ownership of the property, leaseholds, or by churches, factories, clubs or theatres.

10. That mortgages on new buildings which are not completed and productive must not form more than one-tenth of the total of mortgages assigned to and deposited with the trustees under this agreement. No building loans shall be made in New York City without a guarantee, either of the completion of the building or of the repurchase of the mortgage by a corporation in good standing competent to take such a contract, nor in other cities without retaining at all

times from the moneys to be advanced upon the mortgage an amount which the company shall deem sufficient to entirely complete the building according to the plans and specifications.

11. That no real estate shall be acquired except to avoid losses under foreclosure, or to provide offices for the company's own use. All real estate acquired under foreclosure shall be promptly sold.

12. That fire insurance policies to an amount which the company shall deem sufficient to protect the mortgage in fire insurance companies in good standing shall be obtained by the company and deposited with the trustee.

13. That the time within which an action hereunder or upon any of the coupons or bonds of the company may be commenced shall be that now established by the laws of the State of New York, namely, twenty years from accrual of such right of action.

14. That so long as any of the company's bonds shall be outstanding, the company agrees that it shall have an annual audit of its books by independent auditors or chartered accountants, to be designated from time to time by the executive committee of the company.

15. That it will from time to time duly pay and discharge all taxes, assessments and governmental charges lawfully imposed upon the trust fund, or upon any part thereof, and all taxes, assessments and governmental charges lawfully imposed upon the interest of the trustee therein; provided, however, that the company shall not be required to pay any such tax, assessment or governmental charge so long as it shall, in good faith, by appropriate legal proceedings contest the validity thereof.

16. That it will do, execute, acknowledge and deliver, or cause to be done, executed, acknowledged and delivered, all and every such further acts, deeds, transfers and assurances for the better assuring, assigning and confirming unto the trustee each and every bond and mortgage which shall at any time be assigned to and deposited with the trustee or intended so to be, as portion of the trust fund, as the trustee shall reasonably require for better accomplishing the provisions and purposes of this agreement, and for better securing the payment of the principal and interest of the bonds issued and outstanding hereunder.

17. That it will not do or perform, nor voluntarily permit to be done or performed, any act or thing by which the security of this agree-

ment and the assignment and deposit of the bonds and mortgages, which shall from time to time form portion of the trust fund, can be in any way or manner impeached or impaired.

18. That it will well and truly at all times fully inform the trustee in writing, with respect to all payments of principal received by the company from or with respect to any bond and mortgage assigned and deposited hereunder, and will give the trustee such additional information touching any of such bonds and mortgages, or the property covered thereby, as the trustee may reasonably require from time to time.

It may be observed that, in addition to the European requirements, this company has obligated itself so to scatter its investments as to introduce an element of insurance against loss through depreciation due to a possible decline of prosperity of any single community, and, also, that there are important limitations in regard to the size of loans in proportion to the size of the city. In the United States a number of companies are now engaged in issuing real estate mortgage bonds. In some cases these bonds are issued by trust companies, and in other cases by mortgage bond companies especially formed for conducting the mortgage business in the European way.

Rates of Interest

As to the rates of interest which may be obtained on real estate mortgage bonds, these vary with the changes in interest rates on other classes of high grade securities, but in a general way it may be said that, in the United States where mortgage bonds are as yet a somewhat new type of security, these rates are slightly higher than rates on strictly first-class railroad or public service bonds, while in Europe the rates on mortgage bonds are ordinarily slightly lower

than on the same class of railroad and other bonds.

Allowing for the company's profit, borrowers in Europe, prior to the war, usually paid from $3\frac{1}{2}$ per cent to 5 per cent interest on their loans, or an average of somewhat less than 5 per cent with the annual amortization payment included, provided they had good security to offer. The saving in interest to borrowers can be appreciated when we recall that rates in foreign countries ranged from 7 per cent to 12 per cent just prior to the organization of the mortgage business in those countries, and private lenders today commonly obtain considerably higher rates of interest than are charged by the mortgage companies.

General Stability during Periods of Depression

In times of war mortgage bonds have been found to be more stable in value than any other class of security, even government bonds. In times of commercial panics, too, it is observed that these bonds actually rise in value, the exception being that in the period of inflation preceding a panic they are largely sold in favor of more speculative investments, while after a panic there is a desire to invest again in the safer securities.

Convertibility of Investment

The great advantage of the system of issuing bonds which are secured by mortgages, lies in the convertibility which it gives to mortgage investments. These bonds are quoted and dealt in on all the principal European bourses, and their quotations regularly reported in the leading financial papers.

Advantage to the Investor of Mortgage Companies

Looking at the whole matter from the economic point of view, it appears that the charge of the companies is small for the services rendered. For this difference in interest rate of about $\frac{1}{2}$ of 1 per cent between the bonds and the mortgages securing them, the investor obtains safety for his principal and interest, promptness in receiving payment, avoids loss of interest between investments, and can invest any amount he may wish at any time. In contrast with the ordinary mortgage loan, no inspection or appraisal of the property mortgaged is necessary, and the care of looking after fire insurance policies, taxes and assessments and other matters, is done away with; in addition to which, his investment is readily convertible. The borrower gains in having the business conducted by mortgage companies, because of their large resources and the promptness with which they can act on applications for loans, together with low rates of interest and liberal terms of partial or total prepayment; and, further, through the skill and experience of the companies in avoiding poor loans, owners of real estate are deterred from the waste of badly planned or located buildings, and an economic saving of real value is effected.

Advantages of Real Estate Mortgage Bonds

In comparing real estate mortgage bonds with other classes of bonds, there are only two such classes at all comparable in point of safety, namely, municipal and railroad bonds. Undoubtedly one of the principal advan-

tages which real estate has over other forms of security rests in the diversity of its usage. The advantage which railroads enjoy over industrials, in the lower rate of capitalization of their obligations, is largely due to the fact that while any one industry is subject to wide fluctuations in its profits, a railroad, which depends ordinarily on diversified industries, is only affected in a small degree by the failure of a few of the industries upon which it depends. Real estate, of a character suitable for mortgage security, enjoys the same advantage, since its value does not depend upon the success of any one tenant or form of business; and it has the further element of stability, as compared with railroad and public service securities, of being purely private property, and as such not subject to the governmental regulation which is lawful in the case of quasi-public corporations. Advantages which real estate bonds possess over municipal bonds in the United

States consist of a higher rate of interest, and the existence of tangible security supporting the promise to pay. Advantages which they possess over railroad bonds consist of the safety afforded by the fact that the real estate securing each mortgage is worth from 50 per cent to 200 per cent more than the amount of the mortgage, while many, if not most, of the newer railroads are bonded for their full cost of construction, their only margin of safety consisting of a capitalization of their possible excess earning power; and, also, of the fact that the capital stock of the issuing mortgage company, paid in cash, is pledged to make good any losses occurring through the mortgages.

In conclusion, it may be stated that where real estate bonds are properly safeguarded by law they furnish an attractive security of a high type, by combining absolute safety of the principal with a satisfactory rate of interest and easy convertibility.